



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2006/II

A WORLD AGAINST ITSELF

The world appears as if it is riding a train with two engines attempting to move in opposite directions. One of the engines is pulling a thriving global economy—creating jobs, raising living standards in many areas with huge populations, and sparking enlightened discourse and debate that appear to be instrumental in spreading personal freedom and economic opportunity. The other engine, carrying the heavy burden of geopolitics, is dysfunctional and seems to be recklessly pulling the economy onto a path replete with danger. That the future of civilized society will largely be determined by which prevails in this unusual contest can no longer be ignored. At a minimum, the engine of geopolitics could cause growth to sputter, depriving the world of a viable weapon with which to fight the forces of darkness.

The pace of economic revival since the collapse of the Soviet Union has been truly remarkable. Freed from a compulsive attachment to superpower politics, a large number of countries have turned their attention to accelerating economic development and restructuring, with considerable benefits to living standards. These efforts gained further impetus by the unleashing of a technological revolution that seems to know no boundaries. Countries that for decades had cried out for economic and political stability, often moving from one crisis to another, have as a result discovered the wonders of free-market capitalism. At the same time, serious measures are being adopted to dismantle trade barriers and other forms of protectionism that often restrain the spread of prosperity to the less-developed countries. The competitive consequences so unleashed, rather than causing distress, have stimulated productivity, raised profits and margins, reduced inflation and created great wealth that, judging by recent global liquidity measures, is too massive to spend readily. Many countries that for years had relied on the benevolence of others to remain fiscally afloat are currently repaying long-standing debts that as recently as two years ago had been considered uncollectible.

Yet behind such prosperity and blessings lurks uncommon danger that can impede or reverse recent progress. Terrorism has revealed itself as a powerful force of darkness with no articulated objective, no philosophical anchor, no room for compromise, no framework for negotiations and no spokesman with the standing to negotiate any settlement of grievances on behalf of disparate and warring factions.

Movements of national liberation that emerged following the Second World War were largely well-organized and rational. Their objective was singular, to eliminate the colonialist rule and to take control of the political destiny of their countries. They issued well-articulated manifestos, were led by small contingents that acted as the spokesmen of their movements and were always ready to negotiate in good faith. More than fifteen countries—some very large such as India—achieved independence with a minimum of instability and bloodshed.

Today's terrorists are not driven by national aspirations, as they often claim. They have no defined agenda other than to inflict the greatest damage and increase human suffering. Their demands are as irrational as they are mercurial. Their battlefield covers the entire world and their hostile acts are as often directed against their own people, driven by ethnic or religious differences, as against outsiders. The only theme that emerges from their pronouncements is a strong desire to return to the dark ages of tribalism, with the additional absurd demand that the rest of the world follow.

The cradle of today's terrorism is the Middle East, an area that boasts a major portion of the world's oil reserves, a gift of nature that has been more of a curse than a blessing. It has empowered those that control it, as well as those who claim any connection to it, to assume an exaggerated sense of self-importance. Over the past fifty years, huge proceeds from the sale of oil, instead of being invested in economic development in the region, have been largely squandered on frivolous and unproductive pursuits rather than on projects that could have created a diversified industrial base, a huge increase in employment and a broad array of social benefits. Instead, the greatest growth has been in the number of disaffected and hostile terrorists.

For the present, a wave of global prosperity has largely overcome most of the economic damage that this new form of global terrorism has incurred, even though the huge and escalating expense of required security has not guaranteed safety. In due course, when growth begins to sputter, the consequences are certain to become more visible as many countries will be pressed to develop their own political strategies to deal with the issue. As often is the case, such an approach will magnify easily resolved differences among friends and allies, heighten tensions and open all negotiations to blackmail and other forms of deleterious gamesmanship. That such machinations would influence economic and trade decisions should not be ignored. Many recent agreements and negotiations between oil-producing countries and their clients smack of political accommodation, as is apparently the case with deals struck among Iran, Russia, China and others. Similarly, many of the industrialized countries may be pressed into the type of political deals that would place their self-interest ahead of those dictated by principles, as has always been the case in the arena of global power play.

An equally important issue is whether most of the countries that encourage or support terrorist aggression can plant deep economic roots for long-term planning and growth. A large measure of hostility and resentment can be attributed to the economic stagnation and the lack of industrial development across the entire Middle East, where living standards have lagged or regressed over the past sixty years or so, according to a report prepared by the United Nations. Such economic deprivation, despite massive oil wealth, will remain an aggravating factor that will stand in the way of any settlement of outstanding conflicts.

The economic consequences of terrorism are as fearsome as is the well-documented human cost. It is, therefore, irresponsible to approach the conflict merely as a political or logistical problem that ultimately can be addressed and resolved within a framework similar to those adopted in prior national liberation movements. Many civilized, democratic countries have been forced into some compromise of their constitutional freedoms to deal with terrorism in their midst. To prevent further abridgment of human rights, a united approach, undiluted by political self-interest or power play on the global stage, would be required. Otherwise, the recent wave of economic progress and the growing acceptance of democratic ideals in many parts of the world may come to a halt or possibly reverse.

Despite the many concerns expressed elsewhere in this commentary, the U.S. economy appears to be on course to deliver another year of solid growth. The temporary slowdown in business activity experienced during the closing weeks of last year has given way to accelerating momentum on many fronts. Personal consumption is at or above its long-term trend, supported by continued gains in employment and incomes. Government outlays continue to be bolstered by a pressing need to move forward on a recovery plan from the hurricanes, generous commitments to defense, and escalating social requirements. Capital spending, following a relatively slow initial rebound in the current expansion, is rising smartly as businesses seek to protect recent productivity gains, safeguard margins and respond to a sustained rise in capacity utilization. Decisions to add to the nation's plants and equipment are being made easier by strong balance sheets and abundant cash flows.

Fortunately, the economic vigor depicted above does not seem to be awakening inflationary pressures. The spike in industrial commodity prices has apparently slowed or stopped without causing meaningful damage. Organized labor has turned tame in its demands, as a result of which employment costs remain well-contained. In the meantime, global competition is keeping the price of imports in check. Finally, managements are more reliant on gains in productivity than on pricing power to maintain profits.

Moderate inflation should continue to dictate an unthreatening monetary policy. Such appears to be the case currently, with some minor but necessary short-term adjustments. On the domestic front, Chairman Bernanke may attempt to reach the elusive target of "neutrality" while at the same time affirming his reputation as an inflation hawk. He will no doubt need to weigh, and respond to, the recent moves by global central banks that are lifting their interest rates as their domestic growth accelerates.

Much of the debate surrounding the future of the U.S. dollar seems to derive from expanding trade deficits. In the short-term, the dollar should continue to trade within its current range, as it will continue to be helped by moderately higher interest rates, relative political and social stability, critical market liquidity, and by generally better economic growth in the U.S. than in other industrialized countries. Longer-term, changes in the cost structure of U.S. trading partners—notably China and India—and a reduced trade shortfall derived from better energy management may well prevent a further retreat. In any case, currency trading is subject to many economic and political variables that often challenge long-term forecasts.

A weakening housing market has been the subject of intense but frequently uninformed debate. While housing accounts for a major portion of domestic construction activity, other real estate sectors remain quite vigorous, particularly those related to commercial, industrial and public works. Historical data reveals that throughout the 1990s housing starts had been mostly in a range of 1.4-1.6 million units, compared with more than two million recently, a level that had proven sufficient to support the economic boom of that decade. Current estimates suggest that secular demand, based on demographics and other considerations, may now total 1.7-1.8 million units annually. While starts may eventually decline to this lower range, the impact is likely to be moderate. The experience of the United Kingdom, where the housing market began a retreat nearly three years ago, may enlighten. The downturn appears to have reversed in recent months and a moderate recovery is reported at hand. Meanwhile, the adjustment was far less serious than is currently being forecast by the pessimists for the U.S.

One of the most distinguishing characteristics of the current expansion is the liquidity and sound structure of the financial system. Corporate America is generating abundant cash flows, paying down debt, raising dividends and making acquisitions. Withal, its financial resources appear widely to exceed its needs. Meanwhile, the banking system—having largely avoided losses incurred by the technology upheaval of the 1990s—has become overcapitalized, is eager to lend and is making various efforts to expand beyond traditional banking.

On the profit front, the highest margins in more than 40 years are protecting U.S. businesses from the usual attrition that develops as economic cycles mature. In the past, the combination of financing capital outlays, inventories and working capital had strained corporate balance sheets at the same time that interest rates were on the rise. Such is not the case at present. While business spending is at a record, it has been less robust than in past expansions as the industrial base shifts toward less expensive technologies. With balance sheets flooded with liquidity, the need to borrow is both less urgent and less expensive. Such abundance has persuaded companies aggressively to raise dividends over the past three years, though thus far the payout ratio remains at record lows.

In summary, we are of the view that in 2006: (1) the U.S. economy will generate solid growth; (2) inflation will remain tame, or perhaps retreat somewhat, as the year progresses; (3) the central bank will remain on course for further restraint, perhaps moderately surpassing current consensus forecasts; (4) profits will continue to increase, but with a declining rate of gain; (5) the dollar will trade within a broad band, with its current value representing the midpoint of a range; and (6) the U.S. stock market will shake off its lethargy as the end of monetary tightening comes into view, dividends continue to be raised, and merger and acquisition activity escalates.

INVESTMENT STRATEGY: “YOU’VE GOT TO BE IN IT TO WIN IT”

Over the past two years, the U.S. stock market has trailed the underlying fundamentals of the economy. Its plodding, cautious and often erratic advance in the face of explosive growth in profits and cash flows may be attributed largely to widespread media headlines that emphasize or exaggerate the negatives and ignore or downplay a multitude of favorable trends. This disparity between perception and reality has driven down valuations on the Standard & Poor’s 500 to a level not seen in more than ten years, or longer if adjusted for differentials in interest rates.

Factors other than the media’s persistent state of pessimism may also have contributed to this sense of caution. Strong interest in the stock markets of the world, reflecting a broad economic revival, has caused a shift of interest to these developing countries. Fear of the Federal Reserve Board’s determination to continue its policy of restraint also has weighed on the market. A sharp increase in the trade deficit has continued to provoke concern over a possible slide in the dollar. Unease over Washington’s policies, and the consequent decline in President Bush’s popularity, has raised issues of leadership. Finally, the specter of another terrorist attack remains a clear and present danger.

To place all of the above in perspective, there has not been a period in the last one hundred years when a similar litany of uncertainties could not have been invoked to explain whatever sense of foreboding was on display. What differentiates the present from most other such periods in the past is that corporate America today, in most ways, may be in much better economic shape than it has been in nearly 45 years. This conclusion is particularly relevant as it applies to the key financial metrics that define “fair value” for stocks and to which the market is anchored in the long-term. Free of the burdens of geopolitical tensions, U.S. stocks would normally justify significantly higher prices.

The main issue facing investors is the uncertainty of the timeframe required for some of the cited impediments to fade or vanish. On the interest rate front, absent an unexpected spike in inflation, the Federal Reserve Board should end its tightening cycle by late summer, although in the past investors often have successfully anticipated interest rate peaks and acted accordingly. With foreigners significantly underinvested in the U.S., any sign of market momentum may spark a shift from some of the marginal markets that have attracted interest over the past two years or so; as it is, many of the biggest gainers have retreated in recent weeks. In addition, proposed rules to accelerate the funding of retirement plans should add another layer of demand for U.S. equities. Finally, with a huge accumulation of excess cash on balance sheets, the door is now wide open for accelerated repurchases of shares as well as the outright acquisition of publicly traded companies.

The role of hedge funds in the bifurcation of the market as between small- and large-capitalization stocks deserves comment. At present, the largest and most visible companies in the Standard & Poor's 500 are trading at a significant discount to the P/E of the Index. This relative undervaluation can be partly explained by hedge fund trading activities that seek opportunities in the type of volatility not recently typical of the mega names. Furthermore, the significant and persistent outperformance of the small- and medium-capitalization sector may have been heightened by hedge funds, a rising wave of merger and acquisition transactions, as well as the search by private equity pools for suitable candidates in which to deploy a record inflow of cash.

The foregoing leads us to a number of conclusions: (1) On a risk/reward scale, the large capitalization sector of the U.S. stock market appears to offer unique profit opportunities buttressed by clear undervaluation, strong finances and moderate cyclicity. (2) The healthcare industry remains particularly attractive, with emphasis on pharmaceuticals as new product pipelines begin to revive and as finances remain pristine. (3) While we do not advocate the immediate addition to the financial sector, it clearly belongs in the forefront of a "buy" watch list, should a further rise in interest rates place meaningful downward pressure on the group. (4) Defense and aerospace stocks remain attractive, primarily due to security considerations, despite their strong performance over the past two years. (5) As the first quarter came to a close, the energy group reversed its earlier weakness; we would treat the latest upturn as an opportunity to lock in some profits, though we would remain moderately overweighted in the sector. (6) With producer durables and other deeply cyclical sectors having hugely outperformed in recent weeks, we deem it prudent to scale back such exposure on the current run-up. (7) Some of the larger technology companies, many with stellar finances, appear to possess strong potential as capital spending substitutes.

With interest rates still on the rise, average maturities in fixed income should be kept on a short leash. Our preference is for weekly or monthly resets for those investors who can benefit from tax-exempt income. In the taxable bond sector, we are emphasizing high-quality bank finance corporate bonds and avoiding lower credit quality bonds.

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ECONOMIC FORECAST
(AS OF APRIL 1, 2006)

	<u>2003</u>	<u>2004</u>	<u>2005</u>	Estimated <u>2006</u>
Real GDP (Ann. % Change)	2.7%	4.2%	3.5%	3.4%
Real Consumption Expenditures	2.9%	3.9%	3.6%	3.4%
Business Fixed Investment	1.3%	9.4%	8.7%	7.0%
Inventory Investment (Billions)	\$15.5	\$52.0	\$18.5	\$16.8
Residential Construction (Billions)	\$509.4	\$561.8	\$601.8	\$605.0
Government Spending (Billions) (a)	\$1911.1	\$1,952.1	\$1987.0	\$2025.0
Trade Balance-Goods & Services	(\$494.8)	(\$617.6)	(\$723.6)	(\$830.0)
Federal Budget*: Unified (Billions)	(\$374.3)	(\$412.8)	(\$318.5)	(\$375.0)
GDP Deflator	2.0%	2.6%	2.8%	3.0%
Producer Price Index (Finished Goods)	3.2%	3.6%	4.9%	4.6%
Consumer Price Index	2.3%	2.7%	3.4%	3.3%
Industrial Production	0.6%	4.1%	3.2%	4.0%
Real Disposable Income	1.9%	3.4%	1.5%	3.4%
Hourly Compensation	4.0%	4.6%	5.5%	4.7%
Unit Labor Costs (Non-Farm)	0.0%	1.1%	2.6%	2.8%
Productivity Growth (% Change)	3.9%	3.4%	2.9%	2.0%
Personal Savings Rate (% DPI)	2.1%	1.8%	(0.4%)	(0.3%)
Capacity Utilization – Total Industry	75.7%	78.6%	80.1%	81.6%
Trade Weighted \$ Exchange Rate (b)	(12.3%)	(8.2%)	(1.8%)	1.0%
Vehicle Sales (Million Units)	16.7	16.9	16.9	16.6
Housing Starts (Million Units)	1.854	1.950	2.072	1.920
Civilian Employment (Millions)	137.736	139.252	141.73	143.8
Civilian Unemployment Rate	6.0%	5.5%	5.1%	4.6%
Corporate Profits - AT-NIPA	28.2%	11.8%	38.8% (c)	6.8%
S&P-500 Earnings-Reported	\$48.80	\$58.45	\$69.04	\$75.50
S&P-500 Earnings-Operating	\$55.55	\$66.99	\$76.33	\$82.50
S&P-500 Dividends	\$17.60	\$19.25	\$21.75	\$24.25
90 Day U.S. Treasuries-Yield (%)	1.40-0.75	0.86-2.25	2.25-4.03	4.18-5.30
10-Year U.S. Treasuries-Yield (%)	3.17-4.55	3.68-4.87	3.89-4.66	4.32-5.15

*Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2000 dollars; (b) Fed Major Currency Exchange Rate; (c) Artificially boosted due to tax changes.